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STATE PASS TO USTR (EISSENSTAT/MELLE)
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SUBJECT: A LOOK AT MEXICO'S NASCENT PRIVATE EQUITY INDUSTRY

Summary and Introduction

¶1. (U) A strong private equity (PE) and venture capital (VC) industry has long been seen as an important vehicle for economic growth, the development of small- and medium-sized businesses, and job creation. Recent reforms measures and relative political and macroeconomic stability have made Mexico a more attractive market for PE groups. The amount of funds PE/VC firms raised in Mexico increased from approximately $347 million in 2004 to more than $1 billion in 2006, according to the Mexican Private Equity Association (AMEXCAP). That said, most funds focus on companies in their growth stage -- leaving a funding gap for start-ups and early stage companies. Additional measures are needed to strengthen and grow the PE/VC industry. In particular, work is needed to build Mexico's cadre of entrepreneurs, improve laws and regulations that affect PE/VC investments, encourage effective and knowledge management teams, increase the availability of exits, improve rule of law, and promote judicial, labor, educational, and bankruptcy reform. End Summary.

Positive Momentum Is Underway...

¶2. (U) Mexico in recent years has enacted significant reforms to reduce legal impediments to PE/VC investment and to enhance transparency and disclosure. The Securities Market Law -- which went into effect last year -- significantly improved corporate governance and minority shareholder rights through the creation of a special corporate category called an Investment Promotion Corporation (SAPI). A company that registers as a SAPI can avoid some of the requirements of publicly traded companies for three years in return for adopting the "Best Practices of Corporate Governance" code and giving more power to minority shareholders. In 2006, Mexico established a new fiscally transparent trust structure known as the FICAP to allow venture funds to incorporate locally. High management fees charged by banks and brokerage

houses that administer the trust and some lingering concerns about FICAP's corporate governance structure have greatly limited their use, but the creation of this domestic tax pass-through vehicle was an important step nonetheless. (Comment: PE/VC funds pooling resources from several investors incorporate using corporate forms considered as tax pass-throughs, in which tax is applied directly to the investors rather than the fund. End Comment.)

¶3. (U) These reforms, together with relative political and macroeconomic stability in Mexico, have generated growth of domestic and foreign-owned PE funds focused within Mexico's borders. Mexico has approximately 40 active funds, the majority of which are subsidiaries of foreign companies. The amount of funds PE/VC firms raised in Mexico increased from approximately $347 million in 2004 to more than $1 billion in 2006, according to the Mexican Private Equity Association (AMEXCAP), and there is optimism that deal flow will continue to increase over the next few years. That said, most funds focus on companies in their growth stage -- leaving a funding gap for start-ups and early stage companies (i.e. there is very little VC in Mexico). According to a 2006 AMEXCAP and Deloitte survey, the industrial sectors that receive the largest investment from PE funds are real estate, consumer products, and manufacturing, and most investments are in Mexico City, Monterrey, and Guadalajara.

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... But Investment Environment Holds Back Growth
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¶4. (SBU) While the accomplishments discussed above are significant, Mexico must address the following obstacles to

strengthen and grow its PE/VC industry.

Lack of Investment Culture

¶5. (SBU) The lack of an investment culture is routinely cited as one of the top factors hindering the development of Mexico's PE/VC industry. Mexico's history with PE/VC is limited, and knowledge about the financing and benefits of PE/VC is still wanting. Hortensia Contreras, the Director of Investment Capital at Nacional Financiera (strictly protect), told econoff that progress in fostering a venture oriented entrepreneurial culture has been slow because many companies in Mexico are family-owned, and risk-averse owners do not see the need for PE. Carlyle Mexico's Andres Obregon (strictly protect) added that it is not just the entrepreneurs, but also their accountants and advisors who are unfamiliar with the PE/VC model.

¶6. (SBU) Contreras told econoffs that Nacional Financiera (Nafin) is working with Mexican universities to "catch the next generation." She noted how many universities (e.g. UNAM) produce excellent academics and researchers, but not entrepreneurs. Obregon echoed Contreras' comments about the importance of working with universities to build a culture that fosters PE/VC and entrepreneurship. He noted how the major VC funds in the U.S. are located in areas with a high concentration of top-ranked universities (e.g. California and Massachusetts). He highlighted the need to improve public education in Mexico, noting that PE does not affect education, but education affects PE through entrepreneurship and innovation.

Lack of Legal Assurances

¶7. (SBU) The legal uncertainty associated with Mexican judicial processes is a another impediment to PE/VC. The judicial system is generally considered to be slow and unreliable. According to Joaquin Avila, the Managing Director of Carlyle Mexico (strictly protect), judicial

corruption is also a problem.

Local Regulations and Laws

¶8. (U) Additional measures to improve laws and regulations affecting PE/VC are needed. For example, while the FICAP allows companies to incorporate in Mexico, the new trust mechanism's high costs and inefficient structure have resulted in it hardly being used. At the same time, incorporating abroad remains prohibitively expensive for smaller funds. Currently, Mexico does not recognize U.S. partnerships and limited liability companies as fiscally transparent for tax purposes. This prompts many fund sponsors to incorporate in Canada, which is considered a tax pass-through. According to a local consulting company, Mexico does not recognize funds incorporated in the U.S. as tax pass-throughs because of a lack of understanding about U.S. partnerships, pass-through entities, and disregarded vehicles. Some argue that if investment vehicles are considered a tax pass-through under their host country law, the Mexican government should recognize them as pass-through entities as well.

¶9. (SBU) Contreras told econoff that the problem of minority rights of shareholders was solved with the new Securities Market Law, but Obregon noted that there was still a tendency to focus on getting a "51% slice" of the company, and not on the "size of the pie." A 2007 report from the Latin American Venture Capital Association (LACVA) noted that there are some concerns that the prevalence of family and other ties will dilute minority shareholder voices.

¶10. (U) Many investors have argued that Mexico should

increase tax incentives for PE/VC investing. Some say that such incentives should favor only positive investment outcomes and not reward losses.

¶11. (U) Some investors have called for Mexico to lift restrictions imposed on institutional investors for putting money in this industry, noting that pension funds are an important source of U.S. venture funds. The President of AMEXCAP earlier this month said publicly that allowing pension funds to invest in PE would not only help workers retire with a dignified pension but it would also finance a productive activity.

Ineffective Management Teams

¶12. (SBU) According to KPMG's 6th annual Latin American private equity survey, one of the primary causes for deal failure involving PE transactions in Latin America is ineffective management teams. Contreras told econoff that a key to a fund's success in Mexico is high involvement of the fund managers in their investments. She added that funds are trying to create more local management teams to ensure understanding of the Mexican culture, political, business, and legal environment.

Need for Exit Strategies

¶13. (SBU) A vibrant VC industry requires not only investors willing to fund the deals, but also plausible exit strategies for those investors. Contreras told econoff that exits are still a problem because most companies are still too small to do an initial public offering (IPO). She said the government created a private non-regulated middle market company to help, but that Mexico must do more to develop strategies that facilitate exits.

Need for Structural Reforms

¶14. (SBU) Avila told econoffs that economic reforms that improve Mexico's business climate are needed to strengthen the PE/VC industry. He specifically mentioned the need to improve rule of law and for labor and bankruptcy reform.

The Government's Role in Promoting PE/VC

¶15. (SBU) The Mexican government -- with the support of several leading Mexican government financial institutions, including Nafin, Bancomext, Banobras, and Focir -- consolidated its investment into a fund of funds to more efficiently disburse public investment into private sector-run PE/VC funds. This "Fund of Funds" (Corporacion Mexicana de Inversiones, CMIC) started operating in August
¶2006. Contreras told econoff that Nafin now invests only into this fund, and that it has about $200 million committed. Seven new funds have been approved for $100 million and 12 funds, worth $1.5 billion, are being evaluated.

¶16. (SBU) Obregon told econoff that the government should do more to develop the PE/VC industry in Mexico, but he added that the scope of what the government could do is somewhat limited. He said that Mexico needs people who are willing "to go out there and pound the pavement" looking for deals -- something that will only happen if the person will directly benefit from his/her work. In the context of fostering PE/VC, Obregon said that it would be useful to bring experienced venture capitalists to Mexico from the U.S. on a regular basis.

Comment

¶17. (U) Many Mexican officials and economists understand the benefits of having a vibrant PE and VC industry. Mexico is an increasingly attractive market for PE investment, but progress on reforms is needed if this industry is to grow enough to translate into the desired impact on jobs and economic competitiveness. In this context, the importance of improving Mexico's educational system cannot be understated. Advancements in this area are needed to give the country's youth the skills they need to further contribute to Mexico's body of research and development, take advantage of opportunities from NAFTA and globalization, and reduce widespread poverty.

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